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FRANCHISES.

Some years ago a public service corporation in one of our States placed an abnormal and fictitious value upon its franchises to justify its watered stock. It then sought to earn dividends upon this stock by charging the public unreasonable rates. A commission of the State, recoiling from this unwarranted and defenseless corporate action, said, among other things, in its report:

"The commission believes that these franchises, granted by the people without compensation, should not be capitalized against the public, thereby compelling the public to pay a profit upon the value of the favor granted by it."

The people, revolting against corporate greed and monopoly wealth, have demanded the destruction of artificial aids and the rejection of all spurious claims to profits which have not been rightly earned by fair and actual service. Public grants have been curtailed, and "protection" for growing industries has been largely withdrawn. The public is out for its share in public service profits. The ancient theories are called to the bar to be rejudged, and publicists must defend their theories, and legislators must give an account of their doings. Men nominated for high offices must be certified to be immune from corporation virus, and one of the tests of their right to hold public office is their views regarding the right to earn income upon franchise values in corporate hands.

Without argument, and without prejudice, it may be of some aid to civic righteousness to marshal the facts and take note of the law upon the subject of public franchises. The questions for review here are:

1. Is a franchise "property" in the hands of the grantee?
2. If property, has it intrinsic value?
3. If it has value, is that to be taken account of (a) in fixing capitalization? and (b) in determining rates and charges?

I. IS A FRANCHISE PROPERTY IN THE HANDS OF THE GRANTEE?

What is a franchise? Blackstone defines it as "a royal privilege, or branch of the king's prerogative, subsisting in the hands of a subject."¹

Divested of the forms under which it was granted and the particular favors bestowed under monarchical governments and feudal systems, a franchise is a right, privilege, or power, of public concern, which cannot be exercised by private individuals at their will, but must be secured by grant, in some form, from the sovereign power of the territory in which it is to be exercised. It carries with it an assurance of right of user, similar in character to grants of other rights and things, and there is a reciprocal agreement on the part of the grantee to use it in accord with public policy. Kent gives this definition:²

Franchises are "privileges conferred by grant from government, and vested in individuals. . . . They contain an implied covenant on the part of the government not to invade the rights vested, and on the part of the grantees to execute the conditions and duties prescribed in the grant."

In *Society for Savings v. Coite*,³ the Supreme Court of the United States said: "Corporate franchises are legal estates vested in the corporation itself as soon as it is *in esse*," and the Court held that the franchise was property, subject to assessment and taxation against the grantee for the support of the State.

In *Monongahela Navigation Co. v. United States*,⁴ the Supreme Court said:

"If the property is held and improved under a franchise from the State, with power to take tolls, that franchise must be paid for, because it is a substantial element in the value of the property taken. . . . such franchise was as much a vested right of property as the ownership of the tangible property."

In this case it was held that the United States could not condemn and acquire for its own use the improvements of the navigation company in the Monongahela River without paying for the franchise. In other words, although the franchise was a gift from the State, for which nothing was paid, it could not be

¹2 Bl. Comm. *37.

²3 Kent, Comm. *458.

³(1867) 73 U. S. 594, 606.

⁴(1893) 148 U. S. 312, 337, 344.

retaken by the State from the grantee without payment therefor.

In another case⁵ the Supreme Court said:

"It cannot be disputed that franchises of this nature are property and cannot be taken *or used* by others without compensation."

Here, it will be observed, not only the franchise, but *the use* of the franchise is stated to be property which cannot be taken without compensation. In numerous cases, state and federal, this doctrine has been clearly announced with "tiresome repetition."

In nearly every State of the Union, franchises in the hands of the grantees are assessed for taxation under legislative acts. In many States, special taxation is imposed against this class of property.

The grants of franchises are often attended with conditions, and power of revocation is reserved to the State, which affects materially the valuation to be placed upon the franchises. In some States, franchises to public service corporations are granted for an indeterminate period, with provision that the State or municipality may purchase the property and determine the franchise. In such cases, where the purchase is determined upon and the franchise revoked, there would be no value attaching to the franchise that would enter into the purchase price, for the right ceases upon the determination to purchase.

With the question of how to value a franchise, or what its valuation should be, we have nothing to do in this review. Because valuations may be affected by the terms of the grant, and the performance of the assurance on the part of the State not to invade the right rests upon the good faith of the electorate, it cannot be said that franchises are without intrinsic value.

Since the foundation of the government it has been the public policy, both in the States and the federal government, that the ownership should be in, and the operation of railroads and other public utilities should be carried on by, private persons, natural or corporate. To secure the private capital necessary to construct, maintain and operate these utilities it is necessary that public franchises should be granted to them by the State. These franchises have been more or less liberal according to the necessities and the peculiar difficulties in securing facilities requiring private capital. Where the risks are great and the profits in a venture uncertain, larger inducements by way of grants are required and have been

⁵Willcox v. Consolidated Gas Co. (1909) 212 U. S. 19, 44.

given. Two elements form the inducement to private capital to enter into these enterprises: one is the fact that tangible things become of greater value, measured by whatever test applied, when there is added the franchise which enables them to be used for specific purposes not open to private capital acting independently of such franchises; and the other is the prospective advance in values that may come to the property as a result of the operation of such utilities and the growth of population and industries along the line. The property as a whole consists of the tangible things and the right to use them for a specific purpose. These rights thus attached constitute private property within the judicial interpretation of the constitutional provision prohibiting the taking of private property for public purposes without just compensation. The covenants on the part of the public are that the rights so granted, whatever they may be, shall not be invaded except where such a privilege is expressly reserved in the grant. A franchise thus granted becomes a true and in a peculiar sense private property for the period within which it may be enjoyed. There is such a vital relation between the tangible and the intangible property that it is well-nigh impossible to value the one without valuing the other. The tangible property, standing alone, is valuable only for those uses to which it may be put by a private citizen; when these things are assembled into a form for use as a public utility the value is only "scrap" value without the franchise; but when used under the franchise the value is necessarily and greatly enhanced, and this enhancement represents the value of the franchise. To take away the franchise before the right to use it has expired by the terms of the grant is, as has been so often held, a taking of private property, and it would seem to follow, as inevitably, that to deprive the grantee of an income or reward *for the use* of the franchise, is also a taking of private property. In the *Monongahela* case,⁶ the Supreme Court said:

"If the property is held and improved under a franchise from the State, with power to take tolls, that franchise must be paid for, *because it is a substantial element in the value of the property taken. . . . such franchise was as much a vested right of property as the ownership of the tangible property.*"

This answers our first question; the franchise is property in the hands of the grantee.

⁶*Monongahela Nav. Co. v. United States* (1893) 148 U. S. 312, 337, 344.

II. IF PROPERTY, HAS IT AN INTRINSIC VALUE?

The value of intangible property is largely in its effect upon tangible things. A telephone receiver and transmitter may cost very little money to make, but when the government gives, by patent, the exclusive right to make them and dispose of their use, the value of the receiver and transmitter is more than doubled. This is not an artificial value. It is a real, intrinsic value upon which the owner realizes substantial returns; he does so of right, it is not a gift. The patent has not changed or altered the physical condition of the tangible things, but it has added very much to their intrinsic value. So grants of franchises may add very largely to the value of tangible things. Usually these grants are in the nature of legal monopolies. Wood and steel have a fixed market value; but when they are placed in a street under a franchise permitting the operation of street cars and the collection of tolls, these physical things become of greater value. The enhanced value is solely the result of the franchise. Take away the franchise, and the physical property will not scrap at half its cost. A franchise also guarantees the integrity of the investment in things, and makes it possible for the investor to secure a reasonable reward for the use of his property, provided, always, it can be done at reasonable charges. The possession of a franchise then gives to things, commonly designated as "plants", a value as going concerns, with present and future earning capacities and an uninterrupted flow of income, from which expenses of operation, interest, and dividends upon capital may be paid. The whole enterprise rests upon the franchise as its foundation. Withdraw the franchise, and immense loss ensues; the physical property is of little value. It cannot be doubted, therefore, that a franchise is property, and as such it has intrinsic value. These conclusions are supported by the best legal authority and rest upon a sound economic basis.

III. IF IT HAS VALUE, IS THAT TO BE TAKEN ACCOUNT OF (a) IN FIXING CAPITALIZATION? (b) IN DETERMINING RATES AND CHARGES?

Capitalization. Excepting National Banks, there is no federal law which requires that the capitalization of a corporation shall be based upon, and represent actual values. But it is everywhere regarded as sound financiering to make the capitalization the equivalent of the value of the property

owned by the corporation. Some small percentage may be added for financing the enterprise, but with this we have nothing to do in this discussion. Assuming, therefore, that capitalization should be based upon the value of the property capitalized, the question arises, should this valuation include the franchise? We have seen that the franchise is property in the grantee; that the value of tangible property is enhanced by the franchise; and that in case of a purchase or condemnation the franchise value is to be included. It would seem to follow logically and inevitably, from every point of view, that capitalization may represent the true value of all of the property, tangible and intangible, owned and possessed by the corporation. In fact, it is difficult to find, by any process of sound reasoning, an objection to this conclusion.

Just how this valuation shall be arrived at is a matter of little consequence in this discussion. The important fact is that the franchise is in some way to be accounted for in the valuation. In most legislative acts directing the valuation of public service corporations it is provided that the franchise shall be valued separately. This is true of the Congressional act to regulate commerce. There are varying suggestions by accountants and economists as to the method of arriving at the value of a franchise independently. No doubt a jury in a condemnation suit, upon evidence submitted to it, may arrive at an independent estimate of the value of the franchise, if required to do so. This, however, is not essential. The property may be valued as a whole, as railroad property or as an electric light plant. The value of the plant as a going concern, with tangible property and a franchise to operate for a given time, may be valued as a unit. This gives full effect to the claim that franchises should be included in the valuation. In a recent case in the Supreme Court of the United States⁷ this general method seems to have been approved. The court said:⁸

"Then again, although it is argued that the court excluded going value, the court expressly took into account the fact that the plant was in successful operation. . . . On the one side if the franchise is taken to mean that the most profitable return that could be got, free from competition, is protected by the Fourteenth Amendment, then the power to regulate is null. On the other hand if the power to regulate withdraws the protection of the Amendment altogether, then the property is nought. This

⁷*Cedar Rapids Gas Co. v. Cedar Rapids* (1912) 223 U. S. 655.

⁸At pp. 669-670.

is not a matter of economic theory, but of fair interpretation of a bargain. Neither extreme can have been meant. A midway between them must be hit."

If a new railroad is constructed and when ready for operation the physical property has actually cost \$60,000 per mile, and the company has a franchise to operate it as a steam railroad for fifty years, the value of that property, assuming it to be well located, is not \$60,000 per mile, but it is that amount plus the value of the right to operate it as a steam road for fifty years. Suppose we assume that that franchise raises the value of the physical structure fifteen per cent. This would add \$9,000 per mile, which, with some allowance for financiering, might justify a capitalization of \$70,000 per mile. To require it to capitalize for less and sell its stock at par would be compelling the sale of the property at less than it could be acquired for by eminent domain. Capitalization should represent actual purchase value, and purchase value, according to the authorities, clearly includes the value of the franchise. "There is but one value, and that is the value of the structure *in use*."

Rates and charges. As already observed, the franchise increases the value of the tangible property and insures to the investor the opportunity to secure, if possible, a reasonable return upon his investment. This return must be commensurate with the risk which he assumes in establishing the public utility. As the government does not guarantee returns to investors in public utilities, it must necessarily allow a return that will attract capital and compensate the investor for the risk assumed. Any public policy which disregards this fundamental practice will operate to discourage capital and prevent its investment in these securities. If the government desires to acquire these services at the lowest possible price by allowing the investor only the ordinary income upon the actual money paid out, then the government will have to assume the risk and guarantee a fixed income upon the investment to secure further construction by private capital. So long as the present policy of inducing private capital to enter this field of investment prevails, sufficient returns will have to be allowed to make the investments attractive. This may be accomplished upon either of two theories, both of which reach the same result. In fixing the value upon which a return may be earned, the cost of the property (assuming it to be new), together with a fair valuation of the franchise, may be taken as a total valuation—as suggested in the case of capitalization—and a fair return allowed

upon that total, say for illustration, six per cent. Or, the value of the franchise may be omitted and a higher return allowed upon the actual cash investment—say seven per cent. If we assume that the franchise represents one-seventh of the total value for purchase or capitalization, then we have the same result in the latter, as in the former case. This latter method seems to be the favorite one with those who are particularly shy about valuing franchises, their theory being that the public ought not to pay a return upon that which it has given to the corporation without compensation. This theory has its weakness; it is out of line with the law. If the government desires to purchase or lease a piece of ground from a land grant railroad, the land having been conveyed to the company under the land grant act, the government cannot very well say, we gave you this property; it cost you nothing; therefore we will not pay you anything for the use of it. Or, take the case of a patented article. The government says, we want the use of this typewriter; it costs you \$33.50; to be sure, you can sell this for \$100.00, but the difference between the \$33.50 and the \$100.00 represents the value of the patent right which the government gave you and for which you paid nothing, therefore, the public will not pay any rental upon the value of the patent right. Of course, in each instance the government would have to pay the full value if it condemned the land or the typewriter, because the courts have so determined. But valuation for use only is with the administrative department of the government, and, it is said, for the *use* of the property it may not value that which the government gave and allow a return to be earned upon it, for the reason that no compensation was paid therefor. If a *cash* compensation had been paid "we would value that."

It is difficult to see the difference in principle between these illustrative cases and the case where a franchise has been granted. In each case we are dealing with *property of value* in the grantee. And then the premise of the economist is wrong; there is in each grant a satisfactory and valuable consideration to the public. The land grant was given to secure a transcontinental railroad; the patent right, to encourage useful inventions; and, in the case of the public utility, the franchise was given to secure private capital to perform a governmental function. The whole structure of the reasoning of this school seems weak and out of line. It refuses to recognize property values which exist in the grantee according to the long established law of the land.

Perhaps we should not quarrel with the means or method so long as the righteous result is obtained. If a frank, open and strictly fair valuation of franchises and an allowance of a lower rate of interest on the total valuation is objectionable, why then by all means take the valuation of the physical property and increase the rate of interest or return allowed. In buying a horse, the horse dealer said to me: "He is perfectly safe. He will not shy; but if he does, put on blinkers and he will go through."

Among those who like to see a conformity of conduct to law, the feeling will prevail that the better practice in this matter is to conform to the requirements of the acts of Congress and many of the state legislatures, and value the franchises separately. Let us know definitely what valuation is placed upon the physical property and also upon the franchise, and let the two combined be the total valuation of the property of the public service corporation. All fictitious or fanciful valuations of corporate franchises will be, and should be, severely condemned, whether the valuation be made by the corporation or by servants of the government. The valuations of franchises should be strictly fair, adding to the physical or tangible property that increase in value which attaches to it by reason of the franchise right to operate it as a public utility and collect reasonable tolls for services rendered. This method brings the practice into harmony with the law. It recognizes both classes of property, gives full consideration to each class in making the valuation, and then allows a return to be earned upon the total valuation that is comparable with the returns earned in other businesses involving similar risks. Let nothing be done in the administration of public affairs that is radically unsound, and do not seek right results by covert means. Conformity to well established laws, in theory and practice, is the best assurance of a stable government and the prevalence of justice; and publicity in the conduct of public affairs is the best guaranty of civic righteousness.

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